

March 16, 2006

Mary Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd floor
Boston, MA 02110

Re: **Boston Gas Company, Colonial Gas Company, and Essex Gas Company, each d/b/a
KeySpan Energy Delivery New England, D.T.E. 06-9**

Dear Ms. Cottrell:

On January 30, 2006, the Boston Gas Company, Colonial Gas Company and the Essex Gas Company (the “KeySpan Utilities”), each d/b/a KeySpan Energy Delivery New England (“Company” or “KeySpan”) filed a petition with the Department of Telecommunications and Energy (“Department”) for approval, pursuant to G.L. c. 164, § 94A, of a natural gas asset optimization service contract (the “Proposed Agreement”) among KeySpan Utilities, KeySpan Corporate Services, LLC (“KSCS”) and Merrill Lynch Commodities, Inc. (“Merrill Lynch”). The Proposed Agreement would take effect April 1, 2006, for a three-year period terminating on March 31, 2009. Pursuant to the procedural schedule established by the hearing officer, the Attorney General submits this letter as his Initial Brief.

I. Standard Of Review

The Department applies a “public interest” standard of review in evaluating a gas utility's resource options for the acquisition of commodity resources as well as for the acquisition of capacity under G.L. c. 164, s. 94A. *Commonwealth Gas Company*, D.P.U. 94-174A at 27 (1996); *KeySpan Energy Delivery New England*, D.T.E. 04-9 at 10 (2004).

“In order to demonstrate that the proposed acquisition of a resource that provides commodity and/or incremental resources is consistent with the public interest, a local distribution company ("LDC") must show that, at the time of the acquisition or contract renegotiation, the acquisition (1) is consistent with the company's portfolio objectives, and (2) compares favorably to the range of alternative options reasonably available to the company and its customers, including releasing capacity to customers migrating to transportation.” *Id.* “In comparing the proposed resource acquisition to current market offerings, the Department examines relevant price and non-price attributes of each contract to ensure a contribution to the strength of the overall supply portfolio.” *Id.*

“In making these determinations, the Department considers whether the LDC used a competitive solicitation process that was fair, open and transparent.” *Berkshire Gas Company*, D.T.E. 02-56, at 9 (2002); *Bay State Gas Company*, D.T.E. 02-52, at 8 (2002); *KeySpan Energy Delivery New England*, D.T.E. 02-54, at 9 (2002); *Berkshire Gas Company*, D.T.E. 02-19, at 11 (2002). “Specifically, the evaluation process [must be] clearly stated to each potential bidder, evaluation criteria [must be] provided, and there [must be] an opportunity for bidders to request clarification . . . on both the evaluation criteria and the RFP process itself.” D.T.E. 02-56, at 9; D.T.E. 04-9, at 10. “In addition, the bids [must be] evaluated and the winning bid [must be] selected based on the criteria set forth in the RFP. *Id.*

The Department set out standards for margin sharing in D.P.U. 93-141-A. *Interruptible Transportation Investigation*, D.P.U. 93-141-A. “Under D.P.U. 93-141-A, for each category, the LDC must generate margins for each incremental category in excess of the prior year to qualify for sharing the margins with the LDC’s shareholders (or retaining the margins).” *Id.* “If the margins for the current year for any given category are greater than the prior year, the Company increases its customers’ [cost of gas adjustment] CGA costs by 25% of that excess to capture the margin sharing benefit for its shareholders.” *Id.*

II. Argument

The Department should expand its standard of review of non-cost factors given the complexity of the trades associated with asset optimization agreements. The Department should make sure that any optimization agreement results in 1) transparent transactions, 2) a verifiable paper trail contemporaneously created with transactions, and 3) trades that benefit only Massachusetts customers.

The Department should reject the Proposed Agreement because the Company’s competitive selection process failed to provide a “fair, open and transparent” process. D.T.E. 02-56, at 9; D.T.E. 02-52, at 8; D.T.E. 02-54, at 9; D.T.E. 02-19, at 11. The Company made a material change in the nature of services it sought during the competitive selection process, D.T.E. 06-9, March 13, 2006, hearing transcript (Tr.), at 26, and failed to provide all potential bidders with an RFP that accurately reflected the services the Company sought. The original Request For Proposal (“RFP”) the Company sent to potential bidders solicited an asset manager to enter into a complete outsourcing agreement.¹ *Id.*; Exh. KDE-AG-1-1(a)(b). The Company

¹ The New Hampshire Public Utilities Commission has recognized that KeySpan’s Asset Management Agreement (AMA) for its New Hampshire natural gas operations may result in

received initial bids in July 2005 and later received refreshed bids from the original bidders in September 2005 for a complete outsourcing agreement. KED-AG-1-2, Supplemental Response. The Company scored the bids according to criteria that the bidders received with the RFP. Tr. at 21, 23. The Company then selected two bidders from based on the September 2005 bids. Tr. at 23-24.

After the Company selected two bidders, it decided it no longer sought to enter into a complete outsourcing agreement but, rather, wanted to enter into a “co-management agreement.” *Id.* The Company told only the two remaining bidders of this material change in services, and proceeded to negotiate with those two bidders about entering into a “co-management agreement.” *Id.* The Company failure to inform all potential bidders of the material change deprived them of a meaningful chance to bid to provide the Company with asset management services. Potential bidders, given the opportunity to put forth a bid to enter into a “co-management” agreement with the Company, may have put forth a proposal superior to Merrill Lynch’s proposal. The process did not conform to the Departments standards. The Department should reject the Proposed Agreement that resulted from this unfair and opaque process and should order the Company to initiate an RFP process that gives all potential bidders an opportunity to bid to enter into an “co-management agreement” with KSCS to manage KeySpan Utilities’ assets.

The selection process also produced an agreement that fails to meet the Department’s standard for optimization agreements because the Proposed Agreement fails to compare favorably to the range of alternative options reasonably available to the Company and its customers. D.P.U. 94-174A, D.T.E. 04-9. The Company chose Merrill Lynch’s December 2005 proposal over a number of proposals that would have offered a higher guaranteed payment to customers, submitted by Coral Energy and ConocoPhillips, and by Merrill Lynch in September 2005. Exh. KED-AG-1-6 ;Exh. KED-AG-1-2, Supplemental Response; *see generally* Tr. at 21-31 (discussing the selection process). The Merrill Lynch December 2005 proposal offered guaranteed savings to customers at approximately half (or less) of the guaranteed savings in the other proposals the Company rejected.² KED-AG-1-2, Supplemental Response. A review of past earnings shows that the Merrill Lynch December 2005 proposal which gave rise to the Proposed Agreement may not produce the level of savings for customers that they would have enjoyed under the proposals that the Company rejected.³ Exh. KED- DTE-1-6. The Department should reject the Proposed Agreement and order the Company to initiate an RFP process to consider bids that provide more favorable payments to customers.

imprudent transactions and may not have provided any customer benefits. *EnergyNorth Natural Gas, Inc. D/B/A KeySpan Energy Delivery New England*, DG 04-133/DG 04-175, Order No. 24,531 (Oct. 21, 2005) at 17 available at <http://www.puc.state.nh.us/Regulatory/Orders/2005orders/24531g.pdf>. KeySpan decided not to renew its current AMA and to manage gas resources in-house. *Id.*

² CONFIDENTIAL: REDACTED

³ CONFIDENTIAL: REDACTED

The Department should also reject the Company's proposal to circumvent the Department's margin sharing rules set out in D.P.U. 93-141-A. The terms of the Proposed Agreement creates an incentive for the Company to enter into transactions and to procure resources that would maximize margins at the expense of Massachusetts customers. Customers receive a share of any excess margin and the margin sharing appears to benefit customers. The Company, however, has an incentive to use customer dollars to procure assets in excess of customer requirements or to procure high cost assets for use in transactions that would generate excess margins for shareholders. *See* Exh. EDA-3 (setting out the Proposed Agreement's margin sharing terms between customers, KSCS and Merrill Lynch); *see generally* Tr. at 12-15 (discussing margin sharing terms of the Company's proposal). Customers would then pay the cost of excess or high-cost assets through the CGA and the harm from such an added cost may not be off-set by a customer share of the excess margin.⁴

The lack of external checks and audits on transactions under the Proposed Agreement leaves the Department without a means to monitor whether KSCS and Merrill Lynch entered into transactions for the sole benefit of customers. The Proposed Agreement fails to mandate audits of transactions and fails to state risk assessment requirements that could offer some level of customer protection. Exh. EDA-3, Article XII, Section 12.2, at 20; Tr. at 48-53. Moreover, the Company stated it will not audit transactions unless it determines an audit is needed. Tr. at 49-53.

The Company believes that it must enter into a "co-management" relationship with an asset manager to develop in-house capacity to manage its assets. Exh. EDA-1, at 15-17. Although the Company stated that it could provide gas to customers on a daily basis without an asset manager on a short-term basis, Tr. at 33, it made clear that the Company lacks the ability to provide least cost reliable gas service to its Massachusetts customers on a long-term basis. Exh. EDA-1, at 15-17.

[O]ne result of the outsourcing arrangements implemented over the past seven years is that the Company no longer has sufficient in-house capability to purchase and sell gas in the quantities and timelines required to meet its Massachusetts customers' needs, perform nominating and scheduling activities in relation to those purchases, to evaluate and make decisions regarding management issues, or to perform the accounting and bookkeeping requirements of the transactions (i.e., issuance, payment and tracking of invoices associated with gas purchases and opportunity transactions).

KED-EDA-1, at 16-17. The Department should investigate whether the Company's inability to manage basic day-to-day procurement or to optimize its assets over the long-run will harm its customers.

For these reasons, the Department should reject the Proposed Agreement and implement these recommendations in the best interest of the Company's customers.

⁴In a recent order the New Hampshire Commission required EnergyNorth, KeySpan's New Hampshire affiliate, not to renew its asset management contract with MLCI. *Supra* Note 1.

Respectfully submitted,

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Dated: March 16, 2006

cc: Carol Pieper, Hearing Officer
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